

## **8000 NET OPERATING LOSS**

In general, California conforms to IRC §172, modified by R&TC §24416, relating to net operating losses (NOLs). The specific rules for California NOLs have changed over the years however. Prior to 1984, California law did not have a provision for NOLs. From 1984 through 1986, California allowed NOL carryovers in limited situations. These provisions were repealed in 1987. Additionally, most NOLs incurred in 1985 and 1986 were only allowed to be carried over to 1987, 1988 and 1989. The discussion below is limited to NOLs incurred in 1987 and after. If the auditor is examining an NOL that was incurred prior to 1987, the appropriate version of R&TC §24416 should be reviewed.

For California purposes, several different NOL provisions are available. Each NOL has different qualifications, as well as different carryover percentages and periods.

Reviewed: December 2002

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**8010 GENERAL NOL (R&TC §24416)**

Prior to 1994, losses incurred after 1986 could be carried forward at 50% for 15 years. Effective January 1, 1994, the carryover period was shortened to 5 years.

The deduction of general NOLs was suspended for taxable years beginning in 1991 and 1992. However, the carryover period was extended:

If the NOL is incurred in taxable years beginning in 1987 through 1990, the NOL can be carried forward two additional years. As such, 1994 is the last year a NOL incurred in 1987 can be deducted as a NOL carryover.

If the NOL is incurred in a taxable year beginning in 1991, the NOL is allowed to be carried over one additional year, until 1997.

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**8020 QUALIFIED BUSINESS NOL (R&TC §24416.1)**

NOLs incurred from activities conducted in an Enterprise Zone, Program Area, or Los Angeles Revitalization Zone (LARZ) may be carried forward for 15 years at 100%. For years beginning on or after January 1, 1995, losses from business activity in a Local Agency Military Base Recovery Area (LAMBRA) may also be carried forward for 15 years at 100%.

**NOTE:** Program areas and enterprise zone statutes were repealed, effective the close of the applicable 1996 year end. Previous program areas and enterprise zones were then reenacted as enterprise zones effective for taxable years beginning on or after January 1, 1997. R&TC statutes were renumbered and partially changed. All carryover amounts from program areas and enterprise zone incentives are allowed to be carried over under the new enterprise zone provisions.

NOLs are only allowed for the activities conducted in these areas during the time the location was designated as an Enterprise Zone, Program Area, LARZ, or LAMBRA. A listing of the zones or areas and respective approval dates can be found in FTB Publications 1047 (Enterprise Zones) or 1048 (Program Areas – expired for taxable years beginning on or after January 1, 1997), 1044 (LARZ– expired for taxable years beginning on or after January 1, 1998) or FTB Form 3805Z. Further assistance can be received from the Enterprise Zone Specialist at [(916) 845-3464].

The taxpayer must elect to treat the NOL as a Qualified NOL. Generally, the NOL election must be made on the original return. However, since FTB did not distribute the LARZ forms and booklets until August 1993, the 1992 LARZ NOL election can be made on an amended return. The amended return must have been filed by June 30, 1994. This extension does not apply to the Enterprise Zone or Program Area NOL elections. For years starting in 1993 and after, all LARZ elections must be made on the original return. ([FTB Notice 1994-1](#).)

The amount of the NOL generated in one of the above areas is determined based on the apportionment factor formula. The apportionment factor formula differs for each zone or area, and changes over the years at issue. Reference to the specific section is necessary to determine the correct formula.

Reviewed: December 2002

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**8030 NEW BUSINESS NOL (R&TC §24416(b)(2))**

A business that commences in California on or after January 1, 1994 can deduct 100% of the NOL incurred in its first three years of business. The carryover periods are as follows:

1st year's loss carried over 8 years

2nd year's loss carried over 7 years

3rd year's loss carried over 6 years

[Legal Ruling 96-5](#) sets forth the Franchise Tax Board's position as to the scope of the terms "eligible small business" and "new business" as used in R&TC §24416, relating to net operating losses. In addition, [Legal Ruling 99-2](#) clarifies that a water's-edge election will not limit the computation of the asset test for purposes of the new business NOL, or the gross receipts test for purposes of the small business NOL.

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**8040 SMALL BUSINESS NOL (R&TC §24416(b)(3))**

NOLs after January 1, 1994 and incurred by businesses with less than \$1 million in gross receipts can be carried over at 100% for five years.

If a taxpayer qualifies as both a new business for purposes of R&TC §24416(b)(2) and a small business for purposes of R&TC §24416(b)(3), it will be treated as a new business during the first three years of operation.

If the taxpayer is involved in multiple businesses, the rules relating to new business NOLs will be applied first to any portion of the loss that is from a new business, after which the rules for small business NOLs will be applied to any remaining portion of the loss that is from an eligible small business. If the NOL is greater than the loss incurred by the new business and eligible small business, then the excess will be subject to the normal NOL rules (50% of the loss carried over for five years).

[Legal Ruling 96-5](#) sets forth the Franchise Tax Board's position as to the scope of the terms "eligible small business" and "new business" as used in R&TC §24416, relating to net operating losses. In addition, [Legal Ruling 99-2](#) clarifies that a water's-edge election will not limit the computation of the asset test for purposes of the new business NOL, or the gross receipts test for purposes of the small business NOL.

Reviewed: September 2003

**8050 NOL FOR MEMBERS OF A COMBINED REPORT**

Corporations, which are members of a combined report, must separately compute their share of the NOL using intrastate apportionment rules. Likewise, each member of the combined report will have its own NOL carryover that may only be applied against the income intrastate apportioned to that member in subsequent years. (R&TC §25108; see MATM 7900 for an explanation of intrastate apportionment.) An example of the computations involved in determining and applying an NOL in a combined report is included in FTB Publication 1061, *Guidelines for Corporations Filing a Combined Report*.

Reviewed: December 2002

**8060 LIMITATION FOLLOWING OWNERSHIP CHANGE**

R&TC §24451 conforms to IRC §382, pertaining to the carryover of NOLs after certain ownership changes. Special limits generally apply to NOL carryovers when a corporation has any ownership shifts or equity structure shifts that cause the percentage of stock owned by any one or more "5% shareholders" to increase by more than 50 percentage points over the lowest percentage of stock owned by such shareholders during the testing period (usually three years). The NOL carryover limitation is limited to the corporation's value (fair market value of its stock) immediately prior to the change in ownership, multiplied by the federal long-term tax-exempt rate. (Revenue Rulings are issued monthly to publish this rate. The Revenue Ruling for any given month may be found by looking under "interest" in the index of the Internal Revenue Cumulative Bulletin for the appropriate year.) If this limitation exceeds the taxable income, the next year's limitation amount will be increased by the excess amount.

**EXAMPLE**

S Corporation has a \$10 million NOL. On January 1, 1990, B Corporation buys all the stock of S for \$1,000,000. The tax-exempt long-term bond rate on that date is 7.30%. During 1990 S has net income of \$2 million. Under IRC §382, B can use only \$73,000 ( $\$1,000,000 \times 7.30\%$ ) of the NOL carryover.

**EXAMPLE**

Assume the same facts as above, except that S only has \$40,000 in income for this example. S can now offset the full \$40,000 in 1990 and the limitation for 1991 will increase to \$106,000 ( $\$33,000 + \$73,000$ ).

The allowable loss will be reduced to zero if the surviving corporation does not continue the "old" corporation's historic business activity for two years after the date of the ownership change.

**Note:** The IRC §382 limitation applies not only to NOLs, but also to any unrealized built-in losses that exist as of the date of the ownership change. Also, to the extent that the loss corporation has net unrealized built-in gains when the ownership change occurs, the limitation for any one year may be increased by the amount of the built-in gain that is recognized in that year.

This is a very general overview of the IRC §382 limitation, and the actual application of the limitation can become very complex. The federal regulations under IRC §382 are extensive, and auditors should refer to those regulations if issues arise in this area. Auditors should be aware, however, that there are some unique California problems that arise when the federal rules are applied to an apportioning taxpayer.

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Generally, auditors should be alert for IRC §382 issues when a corporation has undergone an ownership change and is deducting NOL carryovers or other losses that are large in relation to the value of the corporation.

Reviewed: December 2002



**8070 NOL FOR WATER'S-EDGE TAXPAYERS (R&TC §24416(c))**

When a water's-edge election is made, the taxpayers sometimes have NOL carryovers that were generated in worldwide years. To the extent that the NOL carryover was generated by a corporation that is not in the water's-edge group due to the water's-edge election, the carryover will not be allowed. To determine whether the NOL carryover is limited, the NOL must be recalculated as if the taxpayer had filed on a water's-edge basis in the year in which the NOL was incurred. Although the carryover may be limited as a result of this recalculation, NOL carryovers cannot be increased based upon a water's-edge recalculation. Examples of the computations necessary to adjust the water's-edge NOL carryover may be found in Chapter 16(c), Water's-Edge Manual.

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**8080 RECOMPUTING PRIOR YEAR NOL CARRYOVERS**

It has been well established through federal case law that income items may be examined and recomputed in years barred by the SOL in order to determine the correct amount of NOL carryover to apply in a current year. Since California conforms to the federal NOL provisions (IRC §172), the case law interpreting those federal provisions is applicable for California purposes (*Lone Manor Farms, Inc. v. Commissioner*, 61 T.C. 436, 440 (1974), *Phoenix Coal Co. v. Commissioner* [56-1 USTC para 9366], *K.C. Hill v. Commissioner*, 95 TC 437 (1990)). Although there are no citable California cases on point, the SBE has upheld the recomputation of NOLs from closed years in a mini-decision (*Appeal of Eastern Trading & Contracting*, 10/5/94). Therefore, if a material NOL carryover is deducted, the auditor should review prior years, even if barred by statute, to ensure that the income that generated the NOL carryover was reported correctly.

This issue can be material in unitary cases where the method of filing in the prior year is incorrect. An adjustment to the prior years' method of filing may reduce or eliminate the NOL carryover. The auditor should also always take into consideration any prior audit findings when examining the NOL carryover deduction.

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